IGNITES

Opinion

B-Ds Should Look to Law Firms, Tech to Fight Finra Fee Waiver Sweep

July 20, 2017

Whitfield Athey is CEO of Delta Data

Finra has been cracking down on advisors' share class selection in retirement and charitable accounts.

When the regulator starting looking in earnest in 2014 it noted that small and midsize broker-dealers that repaid shareholders would be spared regulatory fines if they went ahead and self-reported.

But since a May 2016 sweep letter went out, most in the industry are expecting that leniency to end. And if the actions against larger distributors are any indication, the fines can be significant.

For years, many mutual funds have waived up-front sales charges on A shares held within certain types of retirement accounts. However, Finra discovered in 2014 that some dealers had been charging sales charges on A shares that were entitled to waivers. In other cases, Finra found, investors had been sold B or C shares with back-end sales charges and higher ongoing fees and expenses when lower-cost A shares were available.

Finra then stepped up its oversight of this issue and, through a series of investigations, found that often distributors relied on advisors to waive the sales load, rather than controlling application of the waiver through the home office. Brokers caught selling the wrong versions or failing to waive the sales load were required to reimburse the sales charge overages, plus interest to clients and, in some cases, pay fines.

In the case of small and midsize broker-dealers, Finra said that as long as they self-reported and paid clients back, they could avoid fines.

The Process

Finra's sweep requires brokers to investigate all trades since Jan. 1, 2011, to find all positions for which they were dealer of record at the time of the transaction. Brokers must then rebate load fees (where applicable), plus compounded interest to the investors who were sold improper share classes. Many dealers are still struggling to comply because the waiver eligibility list, a key component of the remediation process, has yet to be compiled and validated.

The process of gathering the correct data about up-front sales charges and management fees that is necessary to calculate the required remediation is extensive. As a result, some broker-dealers face the prospect of having to manually dig through thousands, or even millions, of trades, and read the fine print on all the fund prospectuses.

The calculations involved are extensive, to say the least.

- For A shares sold with a load fee, brokers must determine the load amount, plus interest on the load.
- Where B or C shares were sold when a load-waived A share was available, it is more complicated. In these cases, brokers must calculate a 75-basis-point annual "differentiation" on the purchase amount from the date of purchase up through the date remediation was made or until the shares were sold, in addition to daily compounded interest on that amount.
- If clients sold the shares, the firms also must refund any contingent deferred sales charge (CDSC) along with interest. Such back-end loads are what mutual fund investors pay if they sell B shares sooner than the specific holding period designated in the prospectus.
- Where a client transferred the B or C shares to another broker-dealer, firms must calculate a CDSC fee as if the shares had been sold, then rebate the client that amount plus interest.

The Execution

The initial broker-dealers caught up in the sweep used in-house and/or third-party legal teams to manually compile a waiver eligibility list. They then applied these formulas to the broker-dealer's historical trades to identify the amount that should have been waived for each client, plus interest. That data was then compiled into a remediation file and shared with Finra. Once Finra approved the amounts, companies reimbursed.

The approach was expensive and time-consuming, and deterred smaller broker-dealers from launching proactive investigations into potential liability. Outdated trading platforms and data management systems caused the execution to be laborious, so in many cases, firms are outsourcing the work to third parties.

There are two approaches to outsourcing this task. Some broker-dealers work with law firms that have experience with waivers.

These law firms typically employ paralegals and analysts to review the seven years of trading activity to compile the remediation list. They typically have the sufficient staffing to provide dealers with finely honed data that includes an approved comprehensive list of eligible shares and supporting compliance documentation. They can also provide advice and support during the discussions with Finra representatives.

One drawback is that this approach is typically manual and time-intensive in nature, and billable hours can add up quickly.

In other cases, broker-dealers work with technology firms to employ post-trade analytics systems that automate the process of compiling the remediation list. Systems modified for this purpose can provide fee waiver remediation in a month or two, while the manual process can take much longer.

Broker-dealers that pick this approach use the opportunity to upgrade their data management systems to meet the current need and future regulatory or reporting requirements. However, it can be hard for some firms to justify investing in technology built to comply with regulations, since all signs indicate that the current administration clearly intends to roll back, not increase, compliance requirements.

The Results

Firms that do their homework and put the right plans in place can have confidence that Finra will accept their settlement methodology and calculations leading to a signed AWC. A comprehensive approach is ideal and should help to stop any future problems before they start. It will also keep broker-dealers ahead of any future regulatory changes.